4th Letter to Investors

2H 2023

astercapital

Dear Investor,

In this fourth letter to investors we briefly review the portfolio, and then offer you a deep dive into the company that we see as the most important **digital transformation** currently happening in Brazil: **Itaú**.

After significant increases in both short and long-term interest rates globally in 2022, most markets returned a positive performance in 2023. In the United States, while short-term interest rates continued to rise, 10-year fixed rates remained stable, ending the year at the same level as 2022. The stabilization of long-term interest rate expectations, combined with the 19.4% decline in the S&P in 2022, created conditions for better returns in both developed and emerging markets in 2023.

In Brazil, the scenario improved from 2022. The fiscal situation did not deteriorate in the year, and the yield curve responded positively. While the 3-year fixed rate increased by 198bp in 2022, it decreased by 288bp in 2023.

Given this backdrop, stocks in Brazil also performed positively, and the Ibovespa rose 22.3%. After two challenging years for the stock market in Brazil, we had a year where the positive performance was much broader.

Period	IBOV performance	% IBOV stocks with positive performance
2021	(11.9%)	30%
2022	4.7%	41%
2023	22.3%	66%

Source: Aster Capital and Bloomberg

We view our portfolio as a non-operating holding company of some of Brazil's best businesses, designed to seek solid risk-adjusted returns. This holding company has continued to deliver robust operational performance, which was followed by strong performance of the stocks, and the Aster FIC FIA BDR Nivel 1 was up 31.7% in the period (fact sheet):

Weighted average of the portfolio	3Q23 LTM[1] vs 3Q22 LTM[1]
Revenue growth	22%
EBITDA growth[(a)]	28%
EPS growth[(b)]	26%
ROIC	19%

Source: Aster Capital
(a) Weighted average EBITDA growth excluding MELI and Nubank = 20.2%
(b) Weighted average EPS growth excluding MELI and Nubank = 14.2%

We see the 2023 results of our funds as due to a combination of: strong operational performance by the businesses in our portfolio; the beginning of the easing cycle; and attractive entry multiples.

1. Last twelve months.

Attributions

The following is a brief overview of the three positions that contributed most positively to our performance in 2023: **MercadoLibre**, **Itaú,** and **Equatorial** – in that order:

MercadoLibre (MELI)

MercadoLibre has been the leader in Latin American e-commerce for many years, but in 2023 this consolidation process accelerated. The *Americanas* event helped accelerate MELI's sales growth in Brazil, from around 20% at the beginning of the year to nearly 40% by year-end. This acceleration led to further gains from economies of scale, which, combined with strong performances in digital advertising and fintech, resulted in a significant earnings surprise.

In our estimates, MELI started the year trading at 1-year forward P/E[2] of 44x, then surged in price by 86% in 2023, and ended the year still trading at the same 1-year forward P/E of 44x. Our initial earnings estimate was substantially higher than consensus at the beginning of the year, and even so, we still revised our 2023 EPS forecast by more than 30% over the year.

Itaú

Itaú had a solid year, marked by substantially better delinquency control than its peers, LTM profit growth of 12%, and a comfortable balance sheet. Given its robust Tier 1 Capital ratio of 14.6%, this means Itaú will be able to accelerate its loan growth and increase cash distribution to shareholders.

Even after a price appreciation of 42% in 2023, it is still trading at 1-year forward P/E of 8x, and 6% dividend yield. For 2024, we expect EPS growth of more than 10%, in a year when we expect interest rates to return to single digits.

Equatorial

Equatorial produced exceptional results in 2023, surprising expectations on all fronts of its business: operational excellence, regulatory management, and capital allocation.

It remained focused on service excellence; reducing energy losses; and controlling costs and delinquency. Over the period of 2023, it successfully navigated tariff reviews for its concessions in the Brazilian states of Pará, Piauí, and Goiás, which collectively earn around 50% of its consolidated EBITDA. The tariff reviews led to a positive revision of 10% to 15% in the regulated operational profit for these concessions. Also, it was the first operating year for the recently acquired **CELG** (Goiás Distribution Company), which reported operating profit 30% higher than initially expected.

Based on the 2023 results, we have revised our 2024 estimates upward: EBITDA by 13% and EPS by 17%. Revisions on this scale are noteworthy in a sector often viewed as mature and with limited prospects for incremental surprises.

2. 1-year forward P/E: Price/earnings = (Present stock price) / (Estimated profit in the next 12 months).

The three positions that had the most negative impact on our results for 2023 were **Hypera**, **Assaí,** and **Eletrobras**. Since covered **Assaí** and **Eletrobras** in our last letter, we now comment here on **Hypera**:

Hypera

Hypera operates in pharmaceuticals, an industry which in Brazil has had modest variations in organic market share and generally high ROIC (Return on invested capital). With the significant ageing of Brazil's population, which will continue for many years, we see demand increasing and we expect it to continue to increase in the long term.

However, with Net debt / EBITDA of 2.7x, and operating in a working capital-intensive business, its free cash flow is more sensitive to revenue disappointments – one of which it experienced in 2023, resulting in an earnings revision that led us to find better risk-adjusted returns elsewhere.

Outlook for investment in Brazilian equities

We enter 2024 with a positive outlook for investment in Brazilian equities. We believe the three key drivers that most influence long-term returns in equities – and also explain our performance in 2023, are: (1) entry multiples; (2) the interest rate cycle (cost of capital); and (3) operational performance of the businesses. We currently see all three pointing in the right direction:

1. Entry multiples

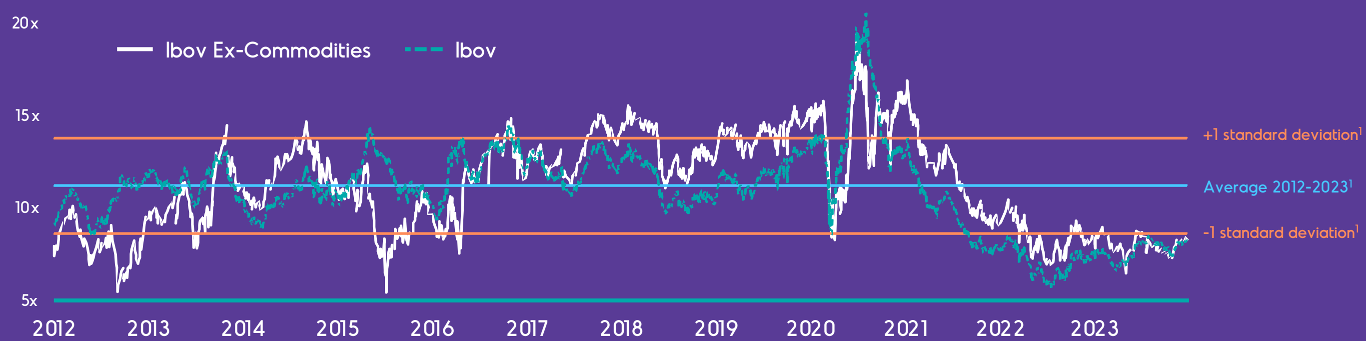
Despite the appreciation of our portfolio throughout 2023, we think that multiples have not yet fully reflected the shift in the interest rate curve. In most cases, the stock performance was more than justified by earnings growth (as in the example of MELI above).

We test this argument in two different ways, and both suggest that the movement in interest rates has not yet been reflected in multiples:

A. Evolution of portfolio multiples in absolute terms: Using both the average portfolio for the year and the current portfolio[3], the weighted average of the portfolio's multiples contracted by 1%, to 4%, over 2023. That is, despite de 31.7% appreciation of the portfolio in 2023, its weighted average 1-year forward P/E did not expand.

B. Long-term history of Ibovespa ex-commodities multiples[4]: We continue to see the Ibovespa trading more than 1 standard deviation below its historical average 1-y forward P/E.

Ibovespa, ex-commodities: 1-year forward P/E



Source: Aster Capital and Bloomberg. 1. Ibov Ex.-Commodities average and standard deviation as of December 31st, 2023

3. The multiple used for this analysis is the 1-year forward P/E.

4. We use the Ibovespa ex-commodities to give a view of the companies most involved with the domestic market – and thus theoretically more subject to Brazil's interest rate cycle.

2. The interest rates cycle

August 2023 marked the beginning of the current easing cycle in Brazil. We do not know the exact magnitude or duration of this cycle, but it followed the largest hiking cycle in the past 20 years, where rates increased from 2% to 13.75%. Over the last 20 years, Brazil has experienced six easing cycles, five of which resulted in positive returns for the Ibovespa.

While we also do not know the terminal rate of this cycle, it is almost certain that Brazil's average interest rates in 2024 will be lower than in 2023. It is also highly likely that they will be lower in 2025 than in 2024. In addition to the potential effects of lower interest rates in terms of acceleration of economic activity and re-rating of multiples, this is a boost for companies' earnings due to lower financial expenses.

3. Operational performance of the businesses in the portfolio

Operational performance is the factor in which we invest most of our time and energy, and also the key source of risks to be mitigated. In 2023, of the five stocks that made the most negative contributions to our performance, we made downward earnings revisions for four.

On the other hand, we continue to see strong businesses in Brazil getting stronger, and expanding their superiority over their peers. Our earnings growth estimates were not modest for the companies in our portfolio, yet the weighted averages over the year of our EPS revisions for 2023 and 2024 for the stocks in our current portfolio were +5% and +9. Of all our EPS revisions, 63% were positive.

The businesses in our portfolio exceeded expectations in a challenging year, and are entering 2024 even better positioned to continue expanding the superiority of their operations.

Digital transformation and the evolution of business models

Digital transformation is the continuous process by which an organization adapts its operational model, adopting operating aspects of a product-based technology company supported by a digital platform.

In Brazil, this process is a response of incumbent companies to the emergence local digital-native companies focused on the end user, since the 2010s, with rapid launches of products and services and strong specialization in economic sectors. The "x_tech" startups – such as fintech, retailtech, healthtech, and edtech – are emerging at a time when B2B and B2C customers, influenced by these new digital experiences, have raised their expectations for the experience, and demand new levels of service from the incumbents.

The wave of investment by incumbent companies in digital transformation projects has been a natural consequence of the three previous waves: mobile applications, migration to the cloud, and the reduction in software development costs.

Initially, this trend is perceived as an internalization of these technological advancements. However, a retrospective view reveals that digital transformation goes beyond the purely technological aspect in non-technical companies. It triggers changes in the business models of these companies, especially in their internal processes that were product and channel-oriented, transforming various aspects of their business by:

- Adopting customer-centric journeys;
- Creating new organizational structures, with teams now having more autonomy and accountability;
- Adapting executive compensation models;
- Embracing an experimental mindset, understanding mistakes as a step in the innovation process, and agility as a method.

The digital-native company starts by seeking a product-market fit that, when successful, evolves into a strong focus on customer acquisition. If this stage works, the business begins to find stability in a model that supports a product or service on digital platforms that operate at scale, allowing the company to grow while reducing both the average unit cost of acquiring customers and the cost of serving these customers. The next step is to add new products and revenue lines with substantially lower marginal costs and expenses than traditional business models.

Unlike the digital-native, the incumbent company does not need transformational innovation to acquire a large customer base, as it already holds this base. It requires an adaptation in certain business aspects to combat these technology-based challengers. So let us look at what these key aspects are.

The three business aspects of digital transformation

1. The Digital Mindset

The **Digital Mindset** may be the most complex of the three business aspects of the digital transformation process. It demands a profound change in the way that teams and executives work together.

In incumbent companies, the most frequent mindset is the maintenance of the status quo. Typically, products and services are already established with a large customer base, and the focus is on operational efficiency. For this reason, team incentives are geared toward maximizing the efficient execution of the existing scope.

Even programs for customer satisfaction improvement often encounter resistance due to the traditional way of operating. This is because they were built upon an incentive system focused on delivering incremental improvements to the existing scope.

2. Agile Methodology

The **Agile Methodology** is the foundation that makes the implementation of a digital mindset possible.

It represents a philosophy that prioritizes agility and adaptability. To achieve this, teams work in short cycles, called sprints, designed to develop, test, and iterate on products rapidly. This enables the organization to adapt to market changes and customer needs.

When developing a new product, digital-native companies often lack the understanding of the market phenomena that will determine the success of that product. Incumbent companies, on the other hand, face a similar lack of knowledge, but related to the scope. The agile methodology seeks to address these uncertainties through agility and adaptability.

Incumbent companies often work with large projects using a waterfall methodology, which assumes that the project's scope is known and has been at least partially executed previously. This implies long-term planning (at least one year) where progression is always forward, without the possibility of going back to reevaluate any individual step. Consequently, mistakes cannot be made, and approval is based on the financial return perspective within that annual budget cycle.

Therefore, deliveries have to be large, with isolated teams apart in silos in their respective domains, and with a performance evaluation process that will be oriented to these same large cycles.

Incumbents face a dual challenge, consisting of efficiently executing the legacy business and, at the same time, innovating in building new products and services supported by a digital platform. The execution of these two fronts demands a deconstruction of the classical way of working, and development of organizational "ambidexterity".

Autonomy and strategic alignment

A key feature of the agile methodology is the autonomy of the teams. However, this autonomy comes with the need for alignment of strategy, and results, ensuring that all efforts contribute to the company's broader objectives.

These teams, called squads, are generally composed of people from three areas: (1) business, (2) technology, and (3) products.

The products, in turn, are technology-enabled offerings – such as tools, services, or experiences – that allow the end user to have a value-generating experience. The product person unites the business team with the technology team and is responsible for ensuring the list of development priorities integrated into the business challenge, and the success indicators, of that squad.

3. Digital Assets

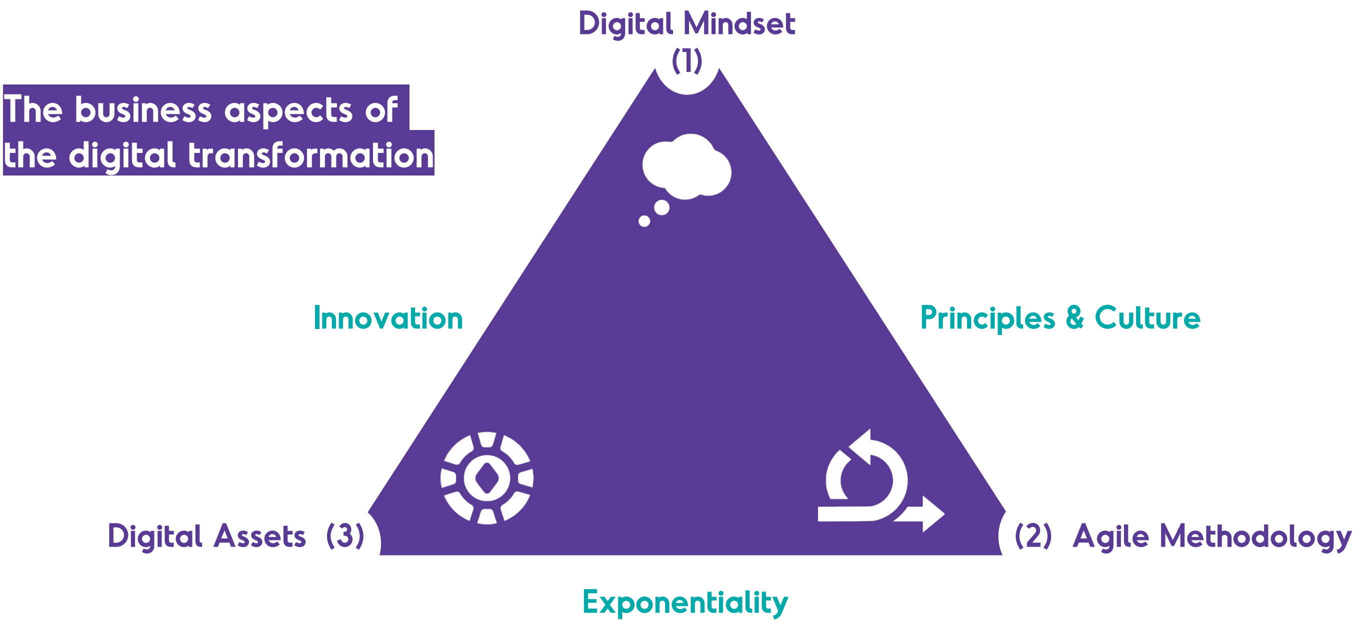
Digital Assets – the third key aspect – are the tangible building blocks of a digital transformation. They include software, hardware, data, algorithms, and user interfaces. These assets allow the multidisciplinary product teams in companies to create innovative and customized solutions for their users. The ability to develop, manage, and reuse these digital assets is fundamental for a company to gain scalability over time.

For the technology teams of incumbent companies, working in a software engineering model with the development of products based on digital assets and supported by a digital platform is almost non-feasible if the company has not already invested in and taken advantage of the previous waves of technology.

The technology architecture of an incumbent company was typically based on on-premise[5] environments, managed by various technology service providers with transactional applications like ERPs (Enterprise Resource Planning) and CRMs (Customer Relationship Management). These applications often have a low level of integration, meaning that data is processed and organized by transactional systems, rather than in a unified and aligned manner with the company's business strategy.

This legacy environment is a hurdle for the development of technology-based products. Several companies tried to execute everything at once, updating their system architecture and, at the same time, applying agile methodologies to change the organizational model but failed in this process.

Combining the three business aspects of the digital transformation creates distinct characteristics in incumbent companies that successfully execute this journey.



5. Environments where hardware, software and IT resources are managed by the company in a physical environment or by outsourced entities.

The **digital mindset** and **agile methodology**, together, create a set of principles and an environment that are essential for the success of a digital transformation. This combination promotes a culture of continuous innovation and quick response to changes, integrating people from different organizational structures towards the same business objectives, creating aligned performance evaluation indicators for squad members. It creates a different challenge for the leadership as they begin to deal with teams that iterate constantly, i.e., experiment, make mistakes, adjust, and again apply the new lessons learned.

The combination of digital mindset with digital assets creates an environment conducive to continuous innovation, where new ideas can be quickly transformed into digital solutions, with rapid deliveries so that, if they fail, they can be corrected quickly and improved, aiming at higher levels of customer satisfaction.

Finally, by combining agile methodology and digital assets, exponential growth may be unlocked. The incremental cost to go from a thousand to a hundred thousand users connected to the same component is marginal, and a modern software development architecture, with continuous deliveries, allows this asset to be reused by other teams within the company, in different markets, without the necessity to rebuild it entirely.

The fintech movement in Brazil

The sector with the highest number of digital-native companies in Brazil is fintechs. By the end of 2023, Brazil had approximately 1,300 startups that fit into the fintech category[6]. This growth in the number of fintechs is explained by several factors: (1) the wave of mobile apps, (2) the rapid adoption of smartphones by Brazilians as the main source of internet access, (3) various changes in sector regulation, and (4) the entrepreneurial desire to access and disrupt Brazil's largest profit pool – banking.

In 2012, the first taxi ride and ride-sharing apps appeared in Brazil, and with them, the need for a frictionless payment process emerged. We all remember the first time we got out of one of these rides with the feeling of not having paid for the ride because of the frictionless payment experience. To build this seamless experience, technology companies rethought the payment service to make it work as a service.

This growing demand for new products and services for a new payment experience was one of the drivers for the Brazilian Central Bank to create and boost a set of regulations starting in 2013[7], which created the concept of payment institutions and mark the beginning of a series of fundamental changes for the development of digital-native companies, the fintechs.

Incumbent banks initially did not worry about these new offerings and changes in consumer behavior. But then they noticed the effect on their customer base when payment accounts without fees and credit cards with smaller but growing limits appeared in the market. Some of these new offerings were successful, and later moved upmarket and became a real threat to the banking principality.

6. 2023 Fintech Report by *Distrito*.
7. Law 12865, of October 9, 2013; and Central Bank Circulars 3680 and 3683 of November 4, 2013.

The digital transformation of Itaú

Itaú, the largest private bank in Latin America, began its digital transformation process in 2017, quietly but steadily, and, in our understanding, is today the most prepared and advanced incumbent bank in this transformation.

In 2008, **Itaú** merged with **Unibanco**, and a new culture was needed to represent the best of these two organizations. This resulting culture brought a pursuit of excellence in products and channels, with profitability indicators at the level of the offerings presented by the branch manager. The bank became an efficient machine, but lacked flexibility for the development of new offerings and products because new products needed to be born efficient and fast, so as not to take up the branch manager's time, and affect their profitability indicator. This was one of the reasons why products related to insurance, for example, did not perform.

Itaú represented a traditional mindset of efficient maintenance of a successful legacy business, with clear processes, product and channel focus, with recurring incremental evolutions and in a hierarchical organizational structure.

First Aspect: Mindset

In May 2017, **Candido Bracher** assumed the presidency of Itaú and brought two significant changes to the bank right at the start of his term: (1) Positioning the customer at the center of the strategy, implementing the NPS[8] (net promoter score) methodology in all areas of the bank and as a component of executives' compensation; (2) Raising awareness among the team about concepts of agile methodology and digital mindset.

In 2020, Itaú began the first changes from the existing organizational model to a community model, better known in agile methodologies as tribes. These are multidisciplinary structures led by business areas but with participants from product and technology areas completing each team.

Second and Third Aspects: Agile Methodology, Digital Assets

In February 2021, **Milton Maluhy** took over as CEO of Itaú and began addressing the missing components necessary to enable the synergy of the agile methodology with digital assets.

The board of directors was also changed: Among others, **César Gon**, founder and CEO of **CI&T**, a specialist in assisting large companies in the digital transformation process, was brought in as an independent member, to accompany **Frederico Trajano**, CEO of **Magazine Luiza**, who was already a board member – two professionals with a robust repertoire to assist the board of directors in the digital transformation process.

At the beginning of **Milton Maluhy's** term, there was already good evidence that Itaú was on the path to a successful digital transformation. But it was still facing a strategic challenge: the loss of talents to digital-native companies that used equity as a tool to attract them.

Maluhy quickly reduced the number of hierarchy levels of the bank's organizational structure, increased the number of members of the executive committee, reduced the number of positions, increased the number of people eligible for the bank's partner program from two hundred to four hundred, and implemented a new phrase in the organizational culture: "We don't know everything".

8. Methodology used to measure customer satisfaction, obtained by evaluating the consumer's propensity to recommend a specific business, product or service.

This phrase summarizes the essence of the synergies of the three aspects of digital transformation: the constant and tireless desire to seek the improvement of a product or service through customer-centered iterations, combined with an environment that protects company participants from punishment for error, and with autonomy for decision-making with accountability.

In Milton's words, **Itaú** goes from a company "made for you" to a company "made with you, the customer".

In our research, we interviewed several people from the technology team, some with over ten years at Itaú. They had similar messages, they were highly motivated because it was "the first time in the bank's history" that they could work with certain technologies and in a modern architecture. We can also observe this in the way the bank works with external technology providers, its cloud migration journey in partnership with AWS, the use of technology from Pismo to support the entire core and credit card operation backend, and how it managed to integrate the teams from Zup acquired at the end of 2019.

Another positive development that we have identified in our research is the adoption of a more modern and structured approach to data. Itaú has managed to merge and democratize a secure access to data among different product communities, which enhances the creation of unique experiences for customers. Over time, products that were originally conceived separately, such as checking accounts and credit cards, can be combined, and the applications where they operate can be unified, marking a new phase of evolution in customer journeys. The challenge of retaining strategic talent for the bank has gradually been addressed.

In December 2023, Milton and his team of directors published a commitment letter with the following points:

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- We want to be the most customer-centric financial services company in the world;
- Obsessed with listening to and understanding the customer;
- Technology is everyone's responsibility;
- We need to use data and AI;
- Challenge the status quo without fear;
- Everything is for the bank, not for just one area;
- Reuse is a priority.

These points show: (1) the synergies between the aspects of digital transformation, such as reuse, focus on data and technology, and (2) the orientation that the digital assets produced are from the bank and not just from one area. They show a company oriented toward product, and supported by the construction, still in progress, of various digital platforms.

Itaú's culture is evolving, and it is the factor that connects and enables the positive transformations to come in this new chapter. An example we found to illustrate this was the table below, showing how the incidence of the word "culture" evolved in Itaú's earnings calls:

	Total # of Earnings Calls	The word "culture": # of uses
Candido Bracher (1Q 2017 – 4Q 2020)	16	2
Milton Maluhy (1Q 2021 – 3Q 2023)	11	54

Source: Aster Capital and company's reports

The effects of Itaú's digital transformation on our investment thesis

Brazil has an economically active population of over one hundred million people, and more than two hundred million smartphones. The fintech movement, along with the acceleration in adoption of digital accounts during the pandemic, has resulted in an almost complete financial inclusion among the Brazilian population. With this in mind, one more statistic:

Our proprietary research suggests that the continuous increase in bank accounts per customer has already exhausted itself, and the game will now be primarily defined by the degree of engagement that institutions have with their customers.

We believe Itaú has found a path to a successful digital transformation process in recent years. It has been able to understand how to create synergies between the three aspects of this process, and even with the competition from some digital-native winners, has been able to maintain its principality with its customer base, and reinforced its potential to develop new products and experiences for these customers.

Our research indicates that **Itaú** is the only incumbent that has not lost principality[9] in the last 3 years, which is consistent with the fact that it also has the highest NPS among incumbents, and a higher concentration of higher-income customers in relation to Brazil's population pyramid. We think it is unlikely that Itaú's solid performance in principality and NPS is not related to the digital transformation it has been carrying out since 2017.

We are entering a new chapter in the history of Brazil's banking sector, as we have not only seen the country's Pix instant-payment service push the country toward the final stages of banking penetration, but we are also entering the most ambitious phases of Open Finance, and soon Drex (the digital currency operated by the Central Bank). These innovations open up opportunities that we expect to disproportionately favor companies prepared to create large-scale offerings supported by digital platforms. We think Itaú is one of the players best prepared to navigate this environment.

We are shareholders of **Nubank**, and we understand that there is still a long way to go in the disruption of Brazil's banking profit pool. At the same time, we see **Itaú**'s thorough process of transformation as a key pillar in our investment thesis, and this is the foundation of why we think that **Itaú** is separating itself from other incumbents and creating the necessary corporate muscles to compete well with digital natives.

Because it has developed these corporate muscles that are in line with and in our view equipped to overcome the challenge it faces today, we see a path of earnings growth for **Itaú** that is positive and superior to that of other incumbents. Because of this diagnosis, we conclude that its 1-year P/E of 8x, combined with a dividend yield of 6%, provide a robust margin of safety, and supports our decision to have Itaú as one our top positions.

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We reaffirm our desire to build a transparent and long-term relationship with our investors. It is important for us that our partners understand us well. We appreciate and value your trust.

The Aster Capital Team

9. Market share in number of main accounts, and the main account criteria being defined by the client himself.

Disclaimer

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